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¶1. (U) Provided below is Embassy Buenos Aires' Economic and Financial Review covering the period June 16 - 20, 2008. The unclassified email version of this report includes tables and charts tracking Argentine economic developments. Contact Econoff Chris Landberg at landbergca@state.gov to be included on the email distribution list. This document is sensitive but unclassified. It should not be disseminated outside of USG channels or in any public forum without the written concurrence of the originator. It should not be posted on the internet.

Highlights

-- BCRA purchasing GoA bonds; reason and impact unclear
-- BCRA posts ARP 7.8 billion profit in 2007
-- Disappointing May primary fiscal surplus
-- GDP up 8.4% y-o-y in Q1, driven mainly by Investment
-- Inflation and Debt evoke ghosts of the past
-- Investment strong in 2007, but not enough to guarantee sustained high growth
-- Fifth Annual Financial Summit optimistic about Argentina's potential for investment and financing in agribusiness and biofuels

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Finance

BCRA purchasing GoA bonds; reason and impact unclear
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¶2. (SBU) Recent press reports allege that the BCRA is buying Argentine government debt. According to a June 17 "Cronista Comercial" article, the BCRA used $800 million of its FX reserves to purchase GoA bonds, while a June 16 "Ambito Financiero" article reports that the purchases reached $1.0 billion and were concentrated in Peso Discounts, GDP Warrants, and Bonar X. (While the BCRA does not release information on its GoA bond purchases, traders interviewed say there is no doubt the BCRA is the buyer.) As of June 6, BCRA reserves stood at $47.7 billion after having reaching a peak of $50.5 billion on March 27. This fall in reserves is mostly explained by the BCRA intervention in the FX market, where it sold $2.7 billion reserves from April 1 through June
¶13. The BCRA's reason for selling dollars sales has been stave off a run on the peso and ease pressures in the FX market, (with the peso seeing retail rate lows of 3.25 ARP/USD on May 9). However, analysts find it hard to explain

the BCRA's continued intervention, which brought the peso to highs of 3.06 ARP/USD on June 18 -- almost a 5% peso appreciation from the 3.15-3.20 trading band of the beginning of the year. Some analysts speculate that it may appreciate further, even surpassing the psychologically important level of 3.0 ARP/USD.

¶3. (SBU) Still, it is even harder for the market to understand BCRA purchases of GoA bonds, and many of Post's financial sector contacts consider it a waste of resources. These analysts wonder what the BCRA will eventually do with the purchased bonds -- i.e., either sell them back to the market or transfer them to a public entity. The analysts also note that the BCRA is probably purchasing GoA bonds to inject peso liquidity (to bring down interest rates), reduced by the BCRA's dollars sales. However, they argue that the BCRA could have done this more easily by purchasing its own short-term debt instruments (Lebacs and Nobacs), rather than buying the 30-year GoA Discount bonds (apparently the preferred bond in BCRA purchases). One of Post's banking sector contacts interprets these purchases as "hidden" lending to the GoA, since the BCRA uses its reserves to finance the purchase but without violating the short-term financing limits (to the GoA) under the BCRA charter. Regardless, analysts agree that BCRA purchases have not helped much to sustain bond prices and reduce yields.

¶4. (SBU) In response to the questions being raised by the market, BCRA President Martin Redrado stated during a June 18 Latin Finance conference in Buenos Aires that "not selling BCRA reserves to contain the foreign exchange market would have been absurd." He also indicated his intention to have the BCRA continue to inject peso liquidity to cool down interest rates. (Interest rates have roughly doubled since March due to BCRA dollar sales.)

BCRA posts ARP 7.8 billion profit in 2007

¶5. (SBU) The BCRA transferred one-third of 2007 profits to the GoA to boost the 2008 primary fiscal surplus. In the face of decelerating GoA fiscal revenues (and increasing expenditures), additional BCRA funds may be forthcoming.

¶6. (SBU) The BCRA earned ARP 7.8 billion ($2.5 billion) in profits during 2007. This compares to the ARP 3.7 billion it earned in 2006, according to the BCRA's report on its 2007 financial results, released June 12. The earnings came from investment of BCRA assets, mainly official reserves, in Euros and gold, both of which have appreciated strongly against the dollar, as well as from BCRA holdings of public bonds. The strong BCRA profits have helped the GoA to boost its primary fiscal surplus. Just through May, the BCRA has transferred ARP 2.5 billion BCRA transfer, an amount significantly higher than the annual transfer of ARP 1.4 million that was included in the 2008 Budget. (The BCRA is obligated to use earnings to increase capital or transfer them to the GoA. So far in 2008, the BCRA transferred to the GoA ARP 1 billion in March, ARP 450 million in April, and ARP 1 billion in May.)

¶7. (SBU) With the strong 2007 BCRA profits, analysts are speculating that the BCRA may continue making transfers -- totaling as much as an additional ARP 5 (about $1.7 billion) -- to the GoA. This would substantially strengthen the GoA's primary fiscal surplus, which many analysts believe is increasingly vulnerable (see item below), and would also ease the GoA's effort to fulfill its 2008 financial needs. (The decision to transfer earnings to the GoA or re-capitalize the BCRA is up to the BCRA's Board of Directors.) Private analysts have expressed concern regarding the vulnerability of GoA fiscal accounts due to the apparent deceleration of the economy -- leading to lower tax collection -- and the increasing pace of subsidies (for details see May 30 Econ/Fin report), as well as pressures to increase public sector wages and pensions due to rising inflation.

Fiscal

Disappointing May primary fiscal surplus

¶8. (SBU) The GoA announced June 19 a record primary fiscal surplus of ARP 6.0 billion ($1.9 billion) for May, a 13% y-o-y increase. However, this strong nominal result hides man ominous trends:

-- May was the first month in 2008 where expenditures grew at a faster pace than revenues: 40% versus 30% y-o-y (nominal) increases, respectively;
-- Correcting for a more realistic rate of inflation (around 25%, as opposed to the official rate of 8 - 9%), the primary fiscal surplus for May dropped 12% y-o-y in real terms;
-- The May primary fiscal surplus would have decreased 6% y-o-y in nominal terms, when excluding the ARP 1 billion earning transfer in May from the BCRA (mentioned in item above); (see clarification below)
-- For the first five months of the year, the accumulated primary fiscal surplus reached ARP 17.7 billion, up 47% y-o-y, significantly lower than the 74% y-o-y increase through April of this year.

¶9. (SBU) The disappointing May result was due to decelerating revenues and accelerating expenditures. With regards to expenditures, which totaled ARP 14 billion, private analysts are most worried about the increase in subsidies, although the increase in public sector wages and pensions (and pressure for even higher increases) is also a major concern. Subsidies -- mainly for energy, transportation and agriculture -- increased 80% y-o-y in May to ARP 4.1 billion, according to the GoA. Note, however, that this does represent a deceleration from the growth rate seen during the first quarter (103% y-o-y; for details see May 30 Econ/Fin Report). Subsidies totaled ARP 16 billion in 2007, and analysts estimate that, based on current trends, GoA subsidies could increase 50% in 2008 to roughly ARP 20-23 billion (or 2 to 2.5% of GDP).

¶10. (SBU) Revenues also performed poorly in May, reaching ARP 20.1 billion, up only 29% y-o-y, only a couple of percentage points higher than true inflation (estimated at around 25%). Within tax collection, activity-related taxes (including VAT, fuels tax, the financial transaction tax) increased 31% y-o-y in May, compared to 39% y-o-y for the first four months of

the year, reflecting a deceleration of the economy in May. Export taxes increased 80% y-o-y in May, compared to an increase of 110% though April, which indicates the impact of the Ag conflict. Local consulting group Bein and Associates estimates that the Ag strike reduced export tax collection by ARP 1 billion in May. Finally, income-related taxes (including income and wealth taxes) increased a weak 2% y-o-y during the month, (compared to 32% y-o-y in the first four months of the year). This was mainly explained by the poor income tax collection, despite May being the month when most companies file their tax forms. Income tax revenue was only ARP 5.3 billion, almost equivalent to May 2007.

Economic Growth

GDP up 8.4% y-o-y in Q1, driven mainly by Investment
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¶11. (SBU) GoA Statistical Agency INDEC (the National Bureau of Statistics and Census) announced June 18 that GDP increased 8.4% y-o-y in the first quarter of 2008, decelerating from 9.1% y-o-y in Q4 2007 and the average of 8.7% y-o-y growth in 2007 (graph below). Investment was the main driver behind the expansion, growing 20.2% y-o-y (and

accelerating from a 15.2% y-o-y growth rate in Q4 2007). This was followed by private consumption, up 8.2% y-o-y (decelerating slightly from 9.3% y-o-y growth in Q4 2007). The increase in investment, which now stands at 22.7% of GDP (measured in constant prices), is due to a 34.8% y-o-y increase in durable equipment investment and a 10.3% y-o-y increase in construction. The growth in durable equipment was mainly from foreign sources, up 46.4% y-o-y, compared to a domestic increase of 16% y-o-y. This increase in imported durable equipment also partly explains the recent deterioration in the trade balance (April's trade surplus was $864 million, down 30% y-o-y). Decelerating private consumption is attributed to the acceleration of inflation and the fall in consumer confidence.

¶12. (SBU) The implicit GDP price deflator for Q1 2008 increased 20.0% y-o-y, higher than the 18.1% increase in Q4 ¶2007. Many analysts are using the GDP deflator as proxy for the CPI, since the latter is not reliable due to the GoA's intervention and tampering with the index. For extensive background, see previous Econ/Fin reports, including Oct 5 and Nov 19 2007; and Jan 18, Feb 8, Apr 18 and Mar 4 2008). For reference, May's CPI increased 9.1% y-o-y. As an alternative to the GDP deflator, which includes all components of demand (investment, exports, private and public consumption), some analysts prefer to use the private consumption price deflator, which increased 15.6% y-o-y -- almost 4.5 percentage points lower than the increase in the GDP deflator. The main shortcoming of using either the GDP or private consumption deflator as a proxy for inflation is that the share of tradable goods and services is larger than in the CPI basket. Thus, these deflators are not exact substitutes for the CPI index.

¶13. (SBU) Most analysts agree that the GoA's manipulation of the price index generates an overestimation of real GDP. However, there is no agreement of the magnitude of the error, with analyst estimates ranging from a marginal difference to as high as a whole one-percentage point of growth. According to the BCRA consensus, 2008 GDP growth is estimated at 7.5%.

Debt and Inflation

Inflation and Debt evoke ghosts of the past

¶14. (SBU) In a June 2008 working paper entitled "Back to the Future," Argentine Institutions and Markets Research Center (CIIMA) from Eseade Business School warns that current GoA debt and inflation levels raise the ghosts of the 2001 economic and financial crisis. The paper states that despite the 2005 debt restructuring, GoA debt levels are now higher than when Argentina defaulted on its debt in 2001 -- the largest sovereign default in history. GoA debt reached $144.7 billion, or 56% of GDP, in December 2007, compared to $144.2 billion, or 54% of GDP, in December 2001. The debt statistics look even worse when including holdout bondholder debt, which currently totals about $28.8 billion. Including holdouts, the public debt stock rises to $173.6 billion, almost 67% of GDP. (See June 13 Econ/Fin report for a slightly more sanguine perspective.)

¶15. (SBU) The paper claims that inflation is undermining confidence, investment, and growth. It also argues that Argentina is facing a new debt crisis because of the GoA's inability to raise funds internationally (due to holdout lawsuits and arrears to the Paris Club) or obtain reasonable interest rates on domestically issued debt. Meanwhile, the GoA faces large debt payments in years 2009-2011. Despite the relatively large primary fiscal surplus, which the paper estimates at 3.6% of GDP for 2008, and the large stock of BCRA reserves (currently about $48 billion), the paper argues that the Argentine economy is vulnerable due to its isolation

from international capital markets and the strong disincentives to investment, especially FDI. The paper further criticizes the GoA for manipulating INDEC's CPI, selling debt to Venezuela (instead of raising funds from markets or IFIs, which have lower costs), increasing expenditures, and raising the fiscal burden on the Ag sector (the most efficient sector in the economy).

¶16. (SBU) The paper predicts a hard landing for the Argentine economy barring significant changes in the policy environment, but notes that its intensity will depend on which of three scenarios plays out:

-- Moderate international crisis while maintaining the current domestic policy mix: domestic expectations deteriorate leading to continuous capital flight, which generate a reduction in the supply of savings and deceleration of consumption, investment, and growth. In two or three years, GDP growth stabilizes around 2-3% in the absence of new productive investment.
-- Domestically originated Crisis: with accelerating inflation and the population's lack of confidence, peso demand falls, which feeds back into further acceleration of inflation. The GoA responds by intervening even more in the economy, exacerbating shortages. (Comment: Implicit in scenarios 1 and 2 is the idea that the trade surplus is not enough to satisfy the dollar demand for capital flight purposes.)
-- International Crisis: the paper argues that a more severe international financial crisis would exacerbate domestic problems, with devastating results (similar impact to scenarios 1 and 2, but with harsher consequences).

¶17. (SBU) To avert these scenarios and continue the current economic expansion, the paper's authors suggest a long to-do list: improving the investment climate and the quality of institutions, strengthening the rule of law, recovering external credit (including settling Paris Club arrears and holdout debt), and restoring the credibility of GoA statistics.

Investment

Investment strong in 2007, but not enough to guarantee sustained high growth
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¶18. (SBU) Fueled by investment in production equipment and construction, aggregate investment hit a 15-year high in ¶2007. However, low investment in some sectors and an uncertain investment climate could hamper sustainable growth.

¶19. (SBU) According to INDEC, investment in 2007 was 22.7% of GDP in constant 1993 pesos, up from 21.6% in 2006, and 1.6% percentage points above its peak in 1998. Investment was the demand component of GDP that grew the most, increasing 14.4% versus 2006, while exports increased 9%, consumption 7.4%, and GDP 8.4%. Investment was concentrated in production equipment (9.4% of GDP) and construction (13.3% of GDP), while, according to analysts, investment in public services, energy, transportation, and logistics was low. Average industrial capacity utilization increased by 23 percentage points between March 2002 and March 2007 (from 50% to 73%), an interesting development given that 80% is the generally accepted limit. High growth continues to attract investors, but capacity still remains for Argentina to meet its potential and improve the quality of investment. (The figures calculate gross investment. Net investment, taking into account depreciation, is lower.)

¶20. (SBU) 2007 FDI was low compared to pre-crisis levels, but has recovered significantly. According to INDEC, 2007 FDI was $5.7 billion, up 13.1% versus 2006, but 34.4% below the annual average in 1993-2000. However, following the 70%

nominal devaluation of the peso in 2002, the "real purchasing power" of each dollar of FDI increased 30.1% on average through 2007 (using INDEC inflation rates to calculate the real exchange rate). FDI as a percentage of total investment is still significant. Due to high annual real GDP growth of 8-9% for the past five years, FDI has been declining as a percentage of GDP even while holding steady in nominal terms. FDI was 2.3% of GDP in 2007, compared to an average of 3.2% of GDP in 1993-2000. According to CEP's ("Centro de Estudios de la Produccion" of the Ministry of Economy) database, of the total "announcements" of FDI in 2007, 33% was for "greenfield" investment and 67% for purchase of or enlargement of existing facilities. By sector, 23% of capital formation went to manufacturing, 34% to infrastructure, 27% to extractive activities, 16% to trade and services, and the rest to primary activities and the financial sector. (Note: CEP's database only provides partial coverage of existing investments, which may result in biases in the conclusions drawn.)

¶21. (SBU) In spite of the strong 2007 performance, investment prospects face major risks: an uncertain regulatory environment and volatile political climate, changing export conditions, a weak judicial system, pervasive corruption, unstable macroeconomic conditions, and scarce financing. Together, these factors are inhibiting investment, which may hamper future growth. The GoA could encourage incremental investment by further developing domestic capital markets and attracting funds from other sources (i.e. FDI), improving the investment climate through clear policies, and implementing stable and predictable rules -- especially related to taxes -- to minimize regulatory risk,

Fifth Annual Financial Summit optimistic about Argentina's potential for investment and financing in agribusiness and biofuels
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¶22. (SBU) Argentina's efficient agricultural sector offers the potential for it to lead the way in biofuel production, but stable rules and an investor friendly climate are needed to increase investment

¶23. (SBU) The fifth annual "Cumbre Financiera Argentina" met June 18-19 in Buenos Aires to discuss financing and investing in agribusiness and biofuels. Day one dealt with investment and capital markets, while day two discussed agribusiness and biofuels. (Background: The International Energy Agency (IEA) estimates that biodiesel production grew nearly 300% from 2000 to 2005, and the IEA's 2006 World Energy Outlook (WEO) forecasts that world output of biofuels will increase 6.3 to 9% annually, meeting 4 to 7% of global demand by 2030.)

¶24. (SBU) A panel discussion entitled "Understanding the Complexity of Agribusiness and Biofuel Financing" emphasized the high risk and high potential involved in investing and financing in agribusiness and biofuel. Argentina's efficient agricultural sector and rising commodity prices offer the potential for high investment returns. However, adverse weather, cyclical prices, high inflation, and GoA intervention in the economy create significant risks. Participants argued that these risks can be mitigated by hedging in the futures market (which is still underdeveloped domestically), but also called on the GoA to create stable rules and forward-looking policies.

¶25. (SBU) The panel entitled "Investing in Agribusiness and Biofuels Assets" examined the issues involved in investment in agribusiness assets, and the strategies that can be used to access them. Panelists emphasized that Argentina has the potential to be a leader in biofuel production, but that this potential is being destroyed by current government policies that increase the fiscal burden of the agriculture sector. They commented that macroeconomic stability, lower inflation, and a more investor-friendly environment are needed to attract more investment.

¶26. (SBU) Financing is difficult to obtain locally due to Argentina's weak capital markets, but participants suggested emulating Brazil as a strategy to develop the biofuel sector: Brazilian ethanol sector subsidization in the late 1970s led to energy self-sufficiency and the doubling of ethanol production between 1996 and 2006. By using export tax revenue to fund temporary subsidies, Argentina could develop the biofuel sector and utilize its comparative advantage in agricultural production. However, competing with Brazil for investment will be a challenge as long as Argentina lacks a

strong legal system and stable and coherent rules.

¶27. (SBU) Difficulties remain for investors regarding securing long-term access to feedstock, a critical component of biofuel production. The three strategies mentioned to secure feedstock included negotiating a deal with a major producer, building a relationship with farmers directly, or using an alternative feedstock. These strategies are problematic since major Ag producers are often producing biofuels themselves, farmers are reluctant to sign long-term contracts, and alternative feedstock such as jatropha have a three-to-four year production lag.

¶28. (SBU) Overall, panelists were optimistic about the growth of the biofuel sector in Argentina. The expected outcome of the GoA's 2008 Washington International Renewable Energy Conference (WIREC) pledge is that at least 5% of Argentina's fuel supply comes from renewable materials by 2011. This is a step in the right direction, but will be difficult to accomplish without GoA commitment to addressing the risk areas mentioned above and ensuring a stable investment climate, lower inflation, and macroeconomic stability.

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